Unsuspecting Franchisors

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I. Introduction

This presentation addresses unusual cases wherein a franchise relationship has been unknowingly formed by parties to a transaction.

II. Definition of a "Franchise"

A. The definition of a franchise under § 31005(a) of the California Corporations Code includes three elements.

A franchise is a contract or agreement, either express or implied, whether oral or written, between two or more persons by which:

(1) A franchisee is granted the *right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor*; (2 subparts of element 1)

(2) The operation of the franchisee's business pursuant to such plan or system is *substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol* designating the franchisor or affiliate;

(3) The franchisee is required to pay, directly or indirectly, a *franchise fee*.

III. Interpretation and Application of the "Franchise" definition

A. **Overview**

1. The reach of federal and state franchise laws is potentially quite broad. If a licensee, agent, or distributor must pay a fee for the right to use the licensor's or manufacturer's mark or simply sells products or services that bear the licensor's or manufacturer's mark and the licensee must comply with certain types of controls imposed by the licensor or the licensor provides certain kinds of assistance to the agent, distributor, or licensee, then the relationship between the parties may be a franchise. See James R. Sims III & Mary Beth Trice, Hidden Franchises, ABA Forum on Franchising, Oct. 22-24, 1997, at 15 [hereinafter Hidden Franchises]; James R. Sims III & Mary Beth Trice, The Inadvertent Franchise and how to Safeguard against it, 18-Fall Franchise L.J. 54 (Fall, 1998); Stephen C. Root, The Meaning of "Franchise" under the California Franchise Investment Law: A Definition in Search of a Concept, 30 McGeorge L. Rev. 1163 (Summer, 1999); California Commissioner of Corporations Release No. 3-F, When Does an Agreement Constitute a Franchise?, Bus. Franchise Guide (CCH) ¶ 5050.45 (Rev. June 22,

1994).

2. A trademark owner that has decided to permit others to use its trademark should therefore either (1) ensure that its proposed relationship with the trademark users does not trigger application of the franchise laws or (2) comply with those laws. [Hidden Franchises]. If the trademark owner does not comply, the owner could find itself in the position of having inadvertently created a relationship that is covered by franchise laws (with corresponding legal liability) even though careful drafting and business planning could have avoided that problem. Id.

B. **What Constitutes the "Right to Engage in the Business of Offering, Selling or Distributing Goods or Services Under a Marketing Plan or System Prescribed in Substantial Part by the Franchisor?"**

1. What Qualifies as a Right to Engage in the Business of Offering, Selling, or Distributing Goods or Services?

a. Gentis v. Safeguard Business Systems, Inc., 60 Cal. App. 4th 1294, 71 Cal. Rptr. 2d 122 (Ct. App. 1998).

i. Safeguard argued that people who solicit orders, but lack authority to enter into binding sales contracts, do not offer, sell or distribute goods or services.

ii. Even if the plaintiff did not have the right to "sell" goods since it could not enter into binding contracts, the definition of a franchise broadly states that the contract gives the franchisee the right to offer or sell or distribute goods or services (use of disjunctive in statute). The plaintiffs did occasionally take possession of Safeguard's goods for delivery, which amounts to distribution (synonymous with disburse, dispense, dole out – Roget's II: The New Thesaurus, at 142). In addition, to offer goods does not require the power to enter into a binding contract. The Court rejected such a narrow interpretation of the California Franchise Investment Law ("CFIL") as contrary to legislative intent. It stated that the reach of franchise law extends beyond "situations where a franchisee has authority to bind the franchisor to a sale of goods; passes title to products; and regularly delivers products to its customers." Gentis, 71 Cal. Rptr. 2d at 127.

iii. What is the difference between a sales representative and a franchised distributorship?

a. A network of sales representatives assigned to a specific area and subject to minimum sales quotas that solicits orders but lacks the authority to bind the grantor to the sale lies outside franchise regulation. Gentis, 71 Cal. Rptr. 2d at 128 (quoting Brooks, When Does a Product Distribution System Become a Franchise or Business Opportunity?, ABA Forum on Franchising, October 1991, 3965-66).

b. The court explained that the "right to sell another's goods and possession of entrepreneurial responsibility distinguishes a franchised distributorship from a sales network." Gentis, 71 Cal. Rptr. 2d at 128.

c. Manufacturer's sales representatives usually do not make an investment in the business distribution of the product, do not carry inventory, cannot alter terms of sales, and do not pay a fee.

d. Here, Gentis was more than a sales representative. It operated an independent business by soliciting orders, giving product demonstrations, solving customer problems, installing systems, contacting customers, generating new business, occasionally distributing directly, setting some prices, and operating under a prescribed marketing plan. Gentis, 71 Cal. Rptr. 2d at 128.

b. Jerome-Duncan, Inc. v. Auto-by-Tel, LLC, 176 F.3d 904 (6th Cir. 1999).

i. Car dealership entered into an agreement with a online service that referred potential car buyers to the dealership. After the online service terminated the contract, the dealership brought suit, alleging that it was a franchisee of the online service.

ii. Both the district court and the court of appeals held that no franchise was created by the parties' relationship. The online service did not grant the dealership any right to offer its customers any goods or services. Rather, the dealership continued to sell cars, and the online service merely referred buyers. "This placed [the dealership] in the position of being [the online service's] customer, not its franchisee. Id. at 910

c. Cawiezell v. The Franklin Life Ins. Co., 2000 U.S. App. LEXIS 33766, Bus. Franchise Guide (CCH) ¶ 12,004 (4th Cir. 2000).

i. A terminated sales manager of an insurance company was not operating a "business" within the meaning of the Illinois Franchise Disclosure Act and therefore could not qualify as a franchise under the Act.

ii. Since all the managers' sales were subject to approval by the company, according to the court, he was not "granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system . . . ." Id. at *19. The court found that because the manager could not bind the company, because the definition of "offer" indicates that an acceptance will create a contract, the manager did not offer or sell the products under the Act and therefore was not a franchise.

iii. But see Gentis v. Safeguard Business Systems, Inc., supra, where the court held that offering does not require the authority to sell.

d. Position of the California Department of Corporations. The Department of Corporations has categorically stated that if no grant of a right to engage in business exists, then no franchise exists. See Commission Opinion Nos. 72/29F, 74/11F and 82/3F (cited by Root, supra, at n. 82).

2. What Constitutes a "Marketing Plan or System" under California Law?

a. Generally, even if a marketing plan is merely "suggested" or labeled "optional" by the "licensor" it can be considered to be "prescribed." See People v. Kline, 110 Cal.App.3d 587, 594, 168 Cal.Rptr. 185 (1980) (marketing plan sufficient to create franchise may be oral or even implied from the circumstances of the relationship);

Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285, 1289 (9th Cir. 1987) (mere promise to sell aggressively, when combined with some specifics, can give rise to a franchise relationship).

b. Thus, it may be necessary for a licensor to withhold any type of marketing assistance in order to avoid granting a “franchise”. See Bowen, What Constitutes a Franchise, IFA’s Annual Legal Symposium, May 13-14, 1996, at 18-19 [hereinafter Bowen]; Detailed recommendations or suggestions on how to conduct business, even if not required by the “licensor” may create the appearance of uniformity and qualify the “optional” “suggestions” as a “marketing plan” as that term is defined under California franchise law.

i. For example, if a supplier provides detailed recommendations or suggestions as to how the business is to be carried out, or provides such information as price lists, signs, promotional materials (e.g., in a sales manual), and requires liability insurance, an appearance of uniformity is likely to arise. See, e.g., Comm. Op. Nos. 73/39F, 72/11F; P&W Supply Co., Inc. v. E.I. DuPont de Nemours & Co., 1991 U.S. Dist. LEXIS 20552 (N.D. Ill. 1991); Salkeld v. VR Business Brokers, 548 N.E. 2d 1151, Bus. Franchise Guide (CCH) ¶ 9557 (Ill. App. 1989).

ii. A nation-wide distribution grid creates an appearance of uniformity since it indicates an “overall plan to make the licensee a link in a chain of business establishments.” (Comm. Op. No. 73/39F)

iii. If all advertising must be approved, an appearance of centralized management and uniform standards exists. (Comm. Op. No. 73/40F)

iv. If training, promotional activities or other arrangements pertinent to the operation of the business are even discussed, recommended or suggested, a marketing plan may be prescribed.

v. Restrictions on prices and limitations on the area of sales are indicative of a marketing plan or system. (Comm. Op. No. 73/47F-license agreement between a California corporation and licensee in Houston)

vi. Authoritative guidance rises to the level of a prescribed marketing plan when the entity that makes the product and gives out licenses tells the franchisee the best way to recruit, sell, train or market. Even though they are unfulfilled promises rather than contractual promises, the significant assistance requirement can still be met. Vaughn v. Digital Message Systems Corp., 1997 CCH Trade Cases ¶ 11,160 (E.D. Mich.) (A Minnesota corporation manufacturing and selling vending machines that dispense personal care items advertised an 800 number for potential distributors. It then sent out promotional materials including a Guide to Success, an introduction letter, and a Protocol Investment Package, Production List and Planner. The distributor was required to purchase 25 machines and would receive support services (which it was not required to utilize)).

c. The following checklist is used to evaluate whether or not a marketing plan or system is “prescribed.” One or a combination of the items on the checklist may be enough to trigger the California franchise law.

i. The grantor’s advertising claims to prospective grantees that a successful marketing plan is available.

ii The contemplation of nation-wide or area-wide distribution on an exclusive or semi-exclusive basis, possibly with multiple levels of jurisdiction (such as regional and local distributorships) designed to establish uniformity of prices and marketing terms.

iii. Reservation of control by the licensor over matters such as customer terms and payments, credit practices, and warranties and representations made to customers.

iv. The licensor's rendering of collateral services to the grantee.

v. Any prohibition or limitation on the licensor's sale of competitive products.

vi. A requirement that the licensee observe the licensor's direction or obtain the licensor's approval for site selection, trade names, advertising, signs, appearance of the licensor's business premises, fixtures and equipment used in the business, employee uniforms, hours of operation, housekeeping procedures, etc.

vii. The licensor's implementation of its requirements regarding the conduct of the business by inspection and reporting procedures.

viii. The licensor's right to take corrective measures which may be at the licensee's expense.

ix. Comprehensive advertising or other promotional programs, especially if the programs identify the location of the licensor and if the licensee's advertising or promotional activities require the licensor's approval. Bowen at 19.

d. Auto-by-Tel, supra. The court of appeals also held that the online service's subscription agreement did not prescribe a marketing plan. Although the online service required the dealership to train one employee as an online representative, dictated the length of time that the dealership must leave an offered price on the table, and closely scripted the interactions between the dealership and those customers referred by the online service, the court was moved by the absence of any day-to-day control over the business decisions of the dealership, and by the fact that the online service did not audit the dealership's books. 176 F.3d at 910-11.

e. Because of the paucity of reported decisions on this issue, the California commissioner of corporations has been placed in the position of having to issue advisory opinions concerning how much control over marketing is necessary to create a franchise. See Inadvertent Franchise, supra, at p. 56 (citing Opinion nos. 73/22F, 4779F and 75/5F).

3. **What Qualifies as a License to Use or a Substantial Association with a Trademark?**

a. In Informal Staff Advisory Opinion 94 2 (February 14, 1994), the FTC staff addressed the "trademark," "significant control or assistance" and "fee" elements. Bowen at 2-3.

i. The seller proposed an agreement by which the buyer, a trade school operator, would purchase software from the seller and, in turn, would provide instruction to students in the operation of the software. Id. Under the agreement, the buyer was required to: (1) provide a marketing plan; (2) attend seminars and pay for these seminars; (3) follow minimum site standards; (4) limit associations with other computer software or hardware sales groups; (5) produce a marketing brochure and mailing; adhere to minimum curriculum standards; (6) employ certain qualified employees; (7) require employees to adhere to the seller's policies and procedures manual; and (8) purchase the software at a discounted price. Id.

ii. In addition, the buyer was permitted, but not required, to use the seller's trade name (ABC) and trademark (Drawright). Id. If the buyer did not wish to use the trademark and trade name, the buyer was required to state that he or she was an "Authorized ABC Training Center for Drawright" or use a similar designation. Id.

iii. In analyzing the trademark element, the staff found that since the buyer would be instructing his or her clients in the use of software identified by the seller's trademark or trade name, this was sufficient to satisfy the trademark element. Id. The staff noted that a federally registered trademark was not required. Id. The staff also pointed out that the seller intended the buyer to benefit from the use of the seller's trademark or trade name, since the buyer was required to identify himself or herself as an "Authorized ABC Training Center for Drawright." Id.

iv. In analyzing the significant control or assistance element, the staff found that the controls under the agreement were "so pervasive" as to be significant. Id.

v. Finally, the staff noted that because the buyer was required to purchase software from the seller, even at a discount, it was possible that the purchases would be at levels sufficient to exceed the minimum payment exemption, although the staff did not have sufficient information to make this determination. Id.

b. In Informal Staff Advisory Opinion 94 9 (December 20, 1994), the FTC staff addressed the "continuing commercial relationship" requirement, and the "trademark," "significant control or assistance" and "fee" elements. Id. at 8.

i. Under a license agreement, the licensor would license its educational computer software to the owner of a group of learning centers. Id. The centers would charge their customers an hourly fee or a membership fee for access to the software. Id. The licensor did not have any experience in operating learning centers. Id. The licensee would be required to pay a one-time license fee exceeding $170,000, and could possibly pay for product support and maintenance services, but would not be required to pay ongoing royalties. Id.

ii. The staff began its analysis by determining that a continuing commercial relationship would be created. Id. Although the license agreement required no ongoing royalties, the learning centers had the right to obtain additional assistance for product support and maintenance from the licensor, in exchange for certain additional fees. Id. The staff found that the availability of this non required additional assistance was sufficient to create a continuing commercial relationship. Id.

iii. Next, the staff evaluated whether the trademark element was present. Id. The learning centers would not operate under the licensor's trade name; however, the learning centers were permitted to use the licensor's trade names and trademarks for advertising that they offered access to the software. Id. The staff found that these facts were sufficient to satisfy the "trademark" element. Id.

iv. The staff next analyzed the significant control or assistance element, and found this element lacking. Id. The staff noted that control or assistance involving a small part of the franchisee's business would not be significant. Id. Under the license agreement, the licensor's assistance was limited to teaching the learning centers how to use the software and providing support and maintenance only as requested by the learning centers. Id. The staff found that this assistance was tangential to the operation of the learning centers. Id. at 9. In addition, the staff noted that the owner of the learning centers was experienced in the sale of computer hardware and training services, did not intend to rely on the licensor's experience in the operation of learning centers (since the licensor had no such experience), and did not expect to reduce the learning centers' risk of failure by entering into the license agreement. Id.

v. The staff also analyzed the fee element, and found this element present. Id. The licensor contended that the initial license fee was a bona fide wholesale price for the right to use the computer software. Id. However, the staff found that the "bona fide wholesale price" analysis was inappropriate, since the software was not purchased as inventory for resale. Id. Customers of the learning centers would not be purchasing the software; rather, they would be purchasing access to the software. Id.

c. Kim v. Servosnax, Inc., 10 Cal.App.4th 1346, 13 Cal.Rptr.2d 422 (Cal. Ct. App. 1992).

i. The California state appellate court determined that the plaintiff was substantially associated with the defendant's mark, despite the fact that the plaintiff was actually prohibited by the agreement from using the mark and the marks were not used or displayed by the plaintiff at the premises or on any goods sold or in any other manner. Hidden Franchises at 18. The business in question was a cafeteria located in an office building and operated pursuant to a contract between Servosnax and the building owner. Id. Servosnax licensed Kim to operate the cafeteria. Id. Even though the marks were not communicated to consumers who patronized the cafeteria, the court found that the communication by Servosnax of the Servosnax name to the building owner, also deemed a customer in connection with establishing and maintaining the business, was sufficient to create the requisite substantial association of the marks with plaintiff's business. Id.

d. Metro All Snax v. All Snax Inc., Bus. Franchise Guide ¶ 10,885 (Dist. Ct. Minn 1996).

i. Even though a distributor never actually used the manufacturer's trademark in its business, the court found a right to use the trademark did exist for purposes of the Minnesota franchise law because the distribution agreement permitted use of the trademark "to the extent necessary." Hidden Franchises at 17.

e. Neptune T.V. & Appliance Serv., Inc. v. Litton Microwave Cooking Prod., 462 A.2d 595, Bus. Franchise Guide (CCH) ¶ 8023 (N.J. Super. 1983).

i The court held that a "license to use" a trademark had been granted from defendant to plaintiff in accordance with the New Jersey Franchise Practices Act ("NJFPA") where the service contract agreement between the parties designated Neptune as "an Authorized Litton service source." Hidden Franchises at 15.

ii. The court based this decision on its understanding that a hallmark of the franchise relationship is the use of another's trade name in such a manner as to create a reasonable belief on the part of the consuming public that there is a connection between the trade name licensor and licensee. The court stated that the permission granted to the plaintiff to hold itself out as an authorized service center induced the consuming public to expect from Neptune uniformly acceptable and quality control service endorsed by Litton. Neptune, 462 A.2d at 599.[2]

f. Instructional Sys. Inc. v. Computer Curriculum Corp., 614 A.2d 124, Bus. Franchise Guide (CCH) ¶ 10,119 (N.J. Sup. Ct. 1992).

i. New Jersey Supreme Court held that a license to use defendant's trademark had been granted where the Reseller Agreement between the parties contemplated that plaintiff, ISI, would use defendant, CCC's, name, trademark and logo, despite the fact that ISI had always operated under its own trade name. Hidden Franchises at 16. The court based its holding on the fact that the product being sold by ISI was not an "off the shelf" product, but rather "a unique combination of hardware and software" whose identity was "integrally related with that of ISI." Id. Additionally, ISI was prohibited from selling any products that were competitive with those of defendant and was required to train users of CCC's products on a regular basis. Id. The "special relationship" between the parties and the fact that customers had "always dealt with ISI as a virtual alter ego of CCC with respect to the purchase and use of CCC products" also contributed to the court's finding that license existed in this case. Id.

g. Rudel Machinery Co., Inc. v. Giddings & Lewis, Inc., Bus. Franchise Guide (CCH) ¶ 11,716 (D.C. Conn. July 15, 1999).

i. For over 45 years Rudel was a sales representative for Giddings, a manufacturer of machine tools, and represented Giddings in two territories. The agreement between Rudel and Giddings provided that either party could terminate the agreement without cause upon written notice to the other party. Giddings terminated the agreement with Rudel when Rudel began representing competing product lines. During the period of the agreement, Rudel had little association with Giddings name. Rudel did not mention Giddings name when answering the telephone, and it was not on Rudel's uniforms, stationary, letterhead or business cards. Rudel claimed that its relationship with Giddings was a franchise under the Connecticut statute and that the termination of the agreement violated the statute because it was not for good cause and the required 60 days notice was not provided. The court held that the relationship was not a franchise because there was no “substantial association” with Giddings trademark. The court found that the substantial association prong would be met if at least most of Rudel’s business was derived from the association with Giddings. In this case, the court found that only about 40% of Rudel’s revenues were attributable to Giddings’ products and held that such percentage was not enough to create substantial association.

h. Auto-by-Tel, supra. The court of appeals also held that the dealership did not distribute goods or services substantially affiliated with the service mark of the online service, because the dealership was not “financially dependent” on the customers referred by the online service. Id. at 911-12.

4. **What Qualifies as a Franchise Fee?**

a. To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc., 152 F.3d 658 (7th Cir. Aug. 6, 1998).

i To-Am arose after Mitsubishi terminated To-Am’s distributorship on relatively short notice, without cause. Mitsubishi assumed the franchise fee test had not been met. See John F. Dienelt & Rochelle B. Spandorf, The 1999 Judicial Update, IFA’s Annual Legal Symposium, May 23-25, 1999, at III-3-4 [hereinafter 1999 Judicial Update]. Problematic for Mitsubishi was not the issue of mandatory purchases of excessive inventory, but the fact that, over the course of the parties eight-year relationship, To-Am had purchased $1600 worth of sales and service manuals from Mitsubishi pursuant to a contractual requirement that it maintain an adequate supply of manuals. Id. Even though the payments were made over time and in small increments, the Court held they satisfied the franchise fee element of the Illinois Franchise Disclosure Act. Id.

b. Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285, Bus. Franchise Guide (CCH) ¶ 8846 (9th Cir. 1987).

i. The court, in dicta, stated that payments made to Sea Ray for videos, films, floats, banners, posters, and brochures used to promote and advertise Sea Ray boats by the dealership were probably franchise fees under California law because they were made at the request of Sea Ray, Sea Ray suggested they were essential, and they were, in fact, essential to the business. Hidden Franchises at 20.

c. US Mac Corp. v. Amoco Oil Company, Bus. Franchise Guide (CCH) ¶ 11,963 (Ca. Ct. App. 2000).

i. The requirement that a lubricator distributor pay Amoco the “established distributor book price minus the discount of $.37 per United States gallon” for lubricant could constitute a hidden franchise fee under the California Franchise Investment Law. If the price paid for the lubricant, even with the discount, exceeded its bona fide wholesale price it could constituted a hidden franchise fee.

d. Duro-Last Roofing, Inc. v. Mayle, 2000 U.S. App. LEXIS 24875, Bus. Franchise Guide (CCH) ¶ 11,953 (6th Cir. 2000).

i. A roofing contractor was not a franchise under the Michigan Franchise Investment Law because optional training fees under the terms of the parties' agreement did not constitute a franchisee fee. Further, the court noted that the contractor never actually paid training fees over the course of the parties' relationship.

ii. An advertising program, "Ads Plus," in which the company would reimburse the contractor for advertising expenditures if the contractor sold more than $50,000 of the manufacturer's products in an individual year, was deemed to be an incentive program rather than a hidden franchise fee.

IV. Conclusion

All three elements must exist before there can be a finding of a franchise. In some instances, it is clear if a business relationship satisfies any or all of the franchise elements. There are instances, however, where parties engaged in a "partnership" or "distributorship" are actually engaging in a franchise relationship subjecting the parties to state and federal franchise law, and are not even aware of it. This presentation serves only to raise potential warning flags for parties that are or may be unsuspecting franchisors.

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[1] The presenter appreciates the contributions of Ryan D. Fischbach, Esq. in preparing these materials.

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[2] The court ultimately held that the relationship between Neptune and Litton was not a franchise because the "community of interest" prong of the NJFPA was not met.
